BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF FAR WEST WATER & SEWER COMPANY, AN ARIZONA CORPORATION, FOR APPROVAL OF INTERIM RATES AND CHARGES.	Docket No. WS-03478A-08-0608

RUCO'S INITIAL CLOSING BRIEF

The Residential Utility Consumer Office ("RUCO") offers this Initial Closing Brief Far West Water Company's ("Far West's") interim rate application ("Application").

I. The Company's Application is Legally Deficient on its Face.

Far West filed its Application for Interim Rates requesting a 101 percent increase in its sewer rates. A Company's ability to receive interim rates is limited to circumstances in which 1) an emergency exists; 2) a bond is posted guaranteeing refund if interim rates are higher than final rates determined by the Commission; and 3) the Commission undertakes to determine final rates after making a finding of fair value.[1] The Attorney General has opined that an emergency exists when "sudden change brings hardship to a company, when a

[1] Residential Utility Consumer Office v. Arizona Corporation Commission at 591, citing Scates.

company is insolvent, or when the condition of the company is such that its ability to maintain service pending a formal rate determination is in serious doubt."[2]

In its Application for Interim Rates, the Company asserts that an immediate increase in revenue is necessary to ensure that the Company "does not become insolvent and unable to continue providing utility services to its customers." The Company admits that it is "not yet insolvent," but that interim rates sought herein would appreciably improve the Company's financial condition."[3] Because the Company did not argue it was insolvent, unable to provide service or suffered a sudden change resulting in hardship, the Company's application is insufficient to grant relief and interim rates should be denied.

In its Application, the Company asserted that its rate of return was a negative 9.23 percent, it was facing the "threat of insolvency" and the threat of insolvency should constitute an emergency necessitating interim rates. Although Arizona's courts recognize that, "in limited circumstances," the Commission may engage in rate making without ascertaining a utility's rate base, the exceptions to constitutional requirements should be narrowly construed.[4] There is no Arizona case which has identified the threat of insolvency as sufficient criteria for an emergency. In fact, in discussing the criteria which constitute an emergency, the Attorney General in Opinion No. 71-17, seems to indicate otherwise.[5] The Attorney General stated that interim rate relief is not proper merely because a Company's rate of return has deteriorated or is unreasonably low. A deteriorating rate of return is not specific to Far West. In the current economy several utilities are experiencing diminishing

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[2] 71-17 Op. Atty. Gen. at 13 (1971).
[3] Application for Interim Rates at 2-3.
[4] Residential Utility Consumer Office v. Arizona Corporation Commission, 199 Ariz. 588, 591 ¶11, 20 P.3d 1169, 1172 (App. 2001). See also Spokane & I.E.R. Co. v. U.S., 241 U.S. 344, 350, 36 S.Ct. 668, 671 (1916) (an "elementary rule" that exceptions from a general policy embodied in the law should be strictly construed).
[5] AG Opinion 71-17(R-52), May 25, 1971.

returns. Because the Company did not claim that it was actually insolvent, its Application is facially deficient and should be denied.

II. The Evidence Presented Shows that the Company is Not Insolvent.

1. The Company's ability to meet debt service and operating expenses should be evaluated on a company wide basis.

In October, 2007, the Commission authorized the Company to enter into a loan agreement with the Industrial Development Authority of the County of Yuma ("IDA") for $25,215,000. The Company sought authorization to issue the bonds to finance additional plant and infrastructure improvements to the Company's sewer system in order to comply with two Consent Orders between the Company and ADEQ and to repay existing debt.[6] The Company asserts that the cash flows of its sewer division are insufficient to meet debt service of $1.9 million on the IDA bonds and fails to consider the cash flows of its water divisions when considering its financial ability to meet its debt service obligations. RUCO disagrees that the sufficiency of cash flows should be determined on the financial statements of the sewer division alone. The Company's witness, Thomas Bourassa testified that he did not necessarily disagree.[7] When the Company submitted its application for financing, it applied for approval on the strength of the combined financial statement of the water and sewer divisions. Because the Company applied for the IDA bonds on a total company basis, the cash flows of both the water and sewer divisions should be available to satisfy the debt service.

The Company asserts that the reliance on the financial resources of the water division results in cross-subsidization of the Sewer Division. RUCO finds this assertion ironic

[6] R-1, Application (Financing), Docket No. WS-03478A-07-0442, Decision No. 69550.
[7] R-3, Testimony of William Rigsby at 13 and A-3, Rebuttal Testimony of Thomas Bourassa at 11, lines 1-6.

because, in this instance, the Company applied for and received financing approval from the Commission ***on a total company basis***.[8] Moreover, the Company used $6.3 million dollars of the IDA bond proceeds to pay off a Water Infrastructure Financing Authority ("WIFA") loan in the amount of $4.4 million and also for water infrastructure projects unrelated to the ADEQ orders in the amount of $1.9 million dollars.[9] Because the water division received $6.3 million dollars from the proceeds of the IDA bonds, it is appropriate to consider the water division's cash flows in determining the Company's ability to meet its debt service and obligations.

2. Debt Service Coverage Ratios ("DSC") and Time Interest Expense Ratios ("TIER") ratios are the appropriate means of evaluating the Company's ability to meet operating expenses and debt service.

In October 2007, the Commission found that Far West had adequate financial strength and approved its request to issue debt of approximately $25 million. In determining whether to approve Far West's financing application the Commission evaluated the Company's ability to meet its debt service using DSC and TIER ratios.[10] A DSC ratio represents the number of times internally generated cash (typically operating income plus non-cash depreciation expense) will cover required principal and interest payments on long-term debt.[11] A DSC ratio that is greater than 1.0 indicates that a utility's operating cash flow is sufficient to cover debt obligations. TIER ratios represent the number of times earnings will cover interest expense on long-term debt. A TIER that is greater than 1.0 means that operating income is greater than interest expense. While a TIER of less than 1.0 is not sustainable over the long run, it does not mean that debt obligations cannot be met on a short-term basis. Id. at 10.

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8 R-1, Application (Financing), Docket No. WS-03478A-07-0442, Decision No. 69950.
9 R-31 Non-ADEQ Expenditures, T: 1074-1076.
10 R-1, Application (Financing), Docket No. WS-03478A-07-0442, Decision No. 69950.
11 R-3, Testimony of William Rigsby at 10.

The Company asserts that the use of DSC and TIER ratios are insufficient to show its ability to meet its debt obligations. T: 906. The Commission should dismiss the Company's arguments for several reasons. First, it is standard in the industry to use DSC and TIER ratios to analyze a company's ability to meet its debt obligations. T: 1056. Second, as a standard practice in reviewing financing applications, the Commission regularly uses DSC and TIER ratios to determine whether a company has sufficient cash flow to incur the debt and repay the indebtedness.[12] Likewise, the Commission relied on the Staff's analysis of DSC and TIER ratios in granting the Company's financing application. T: 904 Third, the Company's expert, Thomas Bourassa used DSC and TIER ratios to evaluate cash flows in his direct testimony. T: 905, referencing Schedule D-1. It is disingenuous for the Company to argue that the ratios are insufficient to evaluate cash flows in surrebuttal when its witness relied on the ratios to evaluate cash flows in his direct testimony.

RUCO's witness, William Rigsby, testified that Far West's financial health has actually improved since its 2007 financing application. He testified that on a total Company basis, the Company has sufficient cash flow to meet its operating expenses and debt service. Mr. Rigsby further testified that at the time the Company submitted its financing application the Staff determined that the proposed debt would result in a pro forma DSC ratio of 1.15. Id. The Staff also determined at the time, that the proposed debt would result in a times interest earned ratio ("TIER") of 0.50. Mr. Rigby testified that Far West's combined operations had DSC ratios of 1.35 in 2007 and 1.49 in 2008, and a TIER of 0.77 and 0.89 for the same years.[13] The Company's DSC ratio and TIER ratios from 2007 and 2008 indicate that Far West's ability to cover its IDA bond debt obligations actually improved since the Commission

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[12] R-30 Staff Report.
[13] R-3, Testimony of William Rigsby at 15. See also Schedule WAR-1.

approved its Financing Application. In terms of free cash flow, Mr. Rigsby testified that Far West had free cash flow of $674,756 in 2007 and $939,066 in 2008, after annual interest and principal payments were satisfied. On a total company basis, the Company has cash flows sufficient to meet its debt service and operational expenses.

The Company asserts that the Commission should stray from its historical analysis of DSC and TIER ratios. Instead, Mr. Bourassa testified that the Commission should use liquidity ratios, like the current ratio or acid-test ratio, to determine the Company's ability to meet its debt service and operating expenses. Liquidity ratios are derived by comparing the Company's assets and liabilities from the Company's balance sheet. Mr. Bourassa computed the current ratio of the company to be .77 by dividing current assets of $3,165,836 by current liabilities of $4,445,590. T: 907. Mr. Bourassa also estimated the acid-test ratio at the end of 2008 to be 0.06 by dividing the company's cash and cash equivalents of $251,546 by its current liabilities $4,445,590. T:913. However, when asked on cross examination to explain the relationship between the liquidity ratios at the time of financing approval and the ratios relevant to the request for interim rates, Mr. Bourassa admitted the Company's current ratio had increased from .59 based on 2006 financials to .71 based on 2008 financials. T: 911 Further, Mr. Bourassa admitted the Company's acid-test ratio had also increased from 0.016 based on 2006 financial statements to 0.06 based on 2008 financial statements. T:914.

RUCO asserts that liquidity ratios are not appropriate to analyze the Company's cash flows because they are based on a utility's balance sheet which includes non-utility related liabilities and assets such as fines, restitutions and penalties. Regardless of what ratios the Commission relies, the increased ratios indicate the Company's financial position has improved since it received approval of its financing application in 2007. T: 1059 Given that the Commission's approval of the Company's financing application was based on the determination that the Company had the ability to repay its debt service and meet its operating expenses, and that the Company's financial indicators are even more favorable now, the evidence does not support a finding of an emergency and the granting of interim rates. On a total company basis, the Company has cash flows sufficient to meet its debt service and operational expenses.

3. The shareholders' inability or unwillingness to cover extraordinary expenses does not render the Company insolvent.

The Company claims that RUCO's analysis is flawed because it does not consider the extraordinary expenses that the Company has incurred to provide adequate service. Extraordinary expenses are nonrecurring expenses unrelated to the ordinary operations of the utility. T: 1060. The Company's extraordinary expenses were associated with effluent removal from Palm Shadows Wastewater Treatment Plant ("Palm Shadows") and the legal defense of the Company and its principals in regulatory and criminal matters.[14]

Cynthia Campbell, ADEQ's Water Quality Compliance Manager, testified and the Company witnesses confirmed that the Company originally obtained a permit to operate Palm Shadows with two evaporation and percolation ponds. However, the ponds were constructed on non-percolating clay soils and did not percolate effluent as designed. Instead of addressing the design flaw, the Company built five more <u>unpermitted</u> evaporation/percolation ponds at Palm Shadows. Upon inspection, ADEQ mandated that the effluent be removed from Palm Shadows because it was stored in unpermitted ponds, and exceeded acceptable volume and nitrate levels.

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[14] R-28 Company's Response to RUCO's DR 6.1.

In 2007, the Company spent $347,446.72 to remove the effluent from Palm Shadows. T: 917. In 2008, the Company testified that ADEQ prohibited further transport of the effluent to the Company's other treatment facilities and mandated the Company make other arrangements for effluent removal. In 2008, the Company spent $501,363.12 to transport the effluent to City of Yuma facilities for processing. Id.

The Company also paid $130,398 and $132,107 for legal fees in 2007 and 2008, respectively. Id. The legal matters involve the defense of the Company's former president who was criminally prosecuted and convicted in connection with the deaths of Company employees who were overcome by gases in a confined space due to inadequate training and supervision.[15] The Company also faces fines, penalties, restitution and civil judgments associated with the incident. The Company's attorneys defended the former officer in the criminal matter, the OSHA proceedings and appellate matters associated thereto. In addition, the Company paid the legal fees and costs associated with the ADEQ matters.[16]

RUCO asserts that these expenses are not recurring expenses and therefore should not be considered in computing cash flows. T: 1052, 1089. The construction of percolation ponds on non-percolating soils and the expenses associated with the death of employees are attributable to poor and negligent management decisions and should not become the burden of the ratepayers. Id. Mr. Rigsby testified that these expenses should be deemed below the line or extraordinary expenses. T:1093 In support of his position, Mr. Rigsby points to the financial statements for 2006, 2007 and 2008 compiled by the Company's private accountant.[17] In each of the annual financial statements, the Company's accountant treats

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[15] A-3,Testimony of Thomas Bourassa, Exhibit 1 Far West's Financial Statements for December 31, 2008 at 12.
[16] R-28 Company's Response to RUCO's DR 6.1
[17] R-1 Financing Application, Exhibit A 2006 Financial Statements of Far West; R-3 Direct Testimony of William Rigsby, 2007 and 2008 Financial Statements Attached Thereto.

these expenses as below the line expenses reflecting that they are the responsibility of the shareholders. As such, RUCO submits they should not be included in the analysis of the Company's cash flows. T: 1052.

Although RUCO does not believe that the expenses should be considered in the determination of the adequacy of the Company's cash flows, Mr. Rigsby analyzed the 2008 financial statements including the effluent disposal expenses of $501,363 and excluding below the line interest income to determine the effect.[18] He testified that even with the inclusion of the additional $501,363 in expenses and excluding the IDA bond interest income for 2008, the DSC and TIER ratios would be 1.23 and 0.58, respectively. Id. He emphasized that these ratios were actually higher than the DSC of 1.15 and the TIER of 0.50 that the Commission relied on to approve Far West's financing application in Decision No. 69950.[19] Regardless of whether the Commission includes below the line income and expenses, the Company's most recent financial statements reflect that on a total company basis, it has a greater amount of cash flow available to meet its debt service and operating expenses than it did when its financing application was analyzed and approved by the Commission in 2007.

4. Compliance with the ADEQ order does not constitute an Emergency

In his surrebuttal testimony, Mr. Capestro, alleged the Company needed interim rates to support the capital investment necessary to comply with the ADEQ orders because the expenses associated with the construction project had increased.[20] More specifically, Mr. Capestro alleged that the Company needed $4,463,820 to finish plant improvements for

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[18] Id at 19. See also R-4 Demonstrative Schedule Showing Calculations in Testimony.
[19] R-3 Direct Testimony of William Rigsby. See also R-1, Application (Financing), Docket No. WS-03478A-07-0442, Decision No. 69950.
[20] A-1 at 8.

Section 14, Del Oro and the Palm Shadows Force Main, $533,045 to complete the Seasons WWTP and $440,045 to construct the Paula Street Lift. Id. at 12.

a. Capital expenses are the shareholders responsibility.

Essentially, the Company is requesting interim rates to pay for capital expenditures. In the opinion of Gerald Becker, Staff's witness, capital budgets are the responsibility of shareholders and should not be used as a basis for determining interim rates. As Mr. Becker explained, operating budgets are the responsibility of ratepayers as they reflect the cost of service. In contrast, capital budgets include the expenditures for plant not yet in service and therefore are the responsibility of shareholders. RUCO agrees with Mr. Becker and asserts that capital expenditures should not be funded at the expense of captive consumers. When the plant becomes used and useful, the shareholders should be allowed the opportunity to earn a fair rate of return on their investment.

b. Misuse of capital funds is not a basis for interim rate relief at the expense of ratepayers.

Although Mr. Capestro initially alleged that the Company needed in excess of $5,000,000 to complete the ADEQ projects, he subsequently modified his testimony. During the hearing, Mr. Capestro clarified that the Company would need $1,272,663 to complete the ADEQ projects and owed past due balances of $3,350,933 to its vendors for a total of $4,623,566. He alleged the Company needed the total amount to complete the projects and pay all past due balances.[21] Mr. Capestro testified that without payment of the past due balances, with few exceptions, vendors would not complete remaining construction projects. RUCO strongly objects to the imposition of interim rates to complete the Company's capital projects. By Mr. Capestro's admissions, the Company spent funding approved by the

[21] A-11 Summary of Amounts Owed and Necessary to Complete.

Commission for ADEQ compliance on projects unrelated to the ADEQ orders. Mr. Rigsby testified that the Company spent $3,739,247 on non-ADEQ sewer and water projects, as follows.[22]

Water related projects (includes Design & Construction 44th Street Water Main Project):	$ 1,883,593[23]
Non-ADEQ Sewer Projects:	
Section 14 (engineering from 1.3 mgd - 2 mgd)	$ 420,000[24]
Section 14 (land for vadose wells to expand to 2 mgd)	$ 201,500[25]
Asset Management & Mapping	$ 246,328[26]
Billing Software	$ 104,800[27]
Sewer AMWS Fuel Dispensing Program	$ 5,931[28]
Fortuna Road Project	$ 269,714[29] (exc. water)
Paula Street Lift Station	$ 607,381[30]
Subtotal Unrelated Sewer	$ 1,855,654
Total Non-ADEQ Expenditures	$ 3,739,247

Mr. Rigsby testified that the amount of money the Company spent on non-ADEQ related projects was roughly equal to the amount the Company owed in accounts payable[31] He opined that if the Company had not misspent the funds, the Company would have sufficient funds available to manage the remaining work. Because the Company's capital

[22] R-31 Non-ADEQ Expenditures, T: 1074-1076.
[23] Exhibit A-8 at 7
[24] Exhibit R-7, Company's response to RUCO DR 5.09
[25] Testimony of Gary Lee and Exhibit A-8 at 6, Disbursement 18B
[26] Exhibit A-8 at 7, Asset Management and Mapping expenses related to water excluded.
[27] Id. Note: Billing Software related to water excluded.
[28] Id. Note: Water Fuel Dispensing Program charges excluded.
[29] Id. Note: Water expenditures on Fortuna Road project, $109,772 are excluded.
[30] Id.
[31] Id.

budget is the responsibility of shareholders[32] and the shareholders admittedly spent funds intended for the ADEQ projects on other non ADEQ related projects, RUCO believes the Commission should deny the Company's request for interim rates to supplement the misspent capital funds. In no event should captive ratepayers be required to pay a 101 percent increase in interim rates to subsidize the shareholders' poor decision-making. Furthermore, Far West used these funds in a manner inconsistent with the terms of Decision No. 69950 that approved its financing application. The Commission authorized the indebtedness for three specific purposes: 1.) sewer system improvements necessary to comply with ADEQ Consent orders; 2.) retire a 1999 WIFA loan; and 3.) retire other short term debt incurred in December 2006 to undertake emergency sewer plant upgrades and improvements necessary to comply with the requirements imposed by ADEQ.[33] Granting interim rates to backfill the misused funds would only serve to reward Far West for its circumvention of Decision No. 69950.

CONCLUSION

On its face, the Company's Application for Interim Rates is legally deficient and should be denied. The evidence demonstrates that on a total company basis, the Company has sufficient cash flow available to meet its debt service and operating expenses. The Company's financial metrics have actually improved since its 2007 financing application. The ratepayers should not have to pay a 101% interim increase in rates to provide capital for completion of the ADEQ ordered improvements. The capital budget is the shareholders

[32] Typically, the capital budget and capital expenditures are the responsibility of management, but in this case the Far West management and its shareholders are the same because Far West is a closely held, developer owned utility.

[33] R-1, Application (Financing), Docket No. WS-03478A-07-0442, Decision No. 69950 at 2.

responsibilities and the fact that the shareholders admittedly misspent the proceeds of the IDA bonds intended to fund ADEQ ordered improvements does not provide a basis for relief. Accordingly, RUCO hereby requests the Commission deny the request for interim rates.

RESPECTFULLY SUBMITTED this 22nd day of June, 2009.

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